No. 19922

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

KAMEN & CO., EDWARD F. LIEBERT, ABRAHAM KAMEN, *et al.*,

Appellants/Cross-Appellees,

vs.

PAUL H. ASCHKAR & COMPANY,

Appellee/Cross-Appellant.

APPELLANTS' REPLY BRIEF AND BRIEF ON CROSS APPEAL.

SHEARER & FIELDS,
BERTRAM FIELDS and
BERNARD SHEARER,
9255 Sunset Boulevard,
Los Angeles, Calif. 90069,
Attorneys for Appellants and Cross-Appellees.

Parker & Son, Inc., Law Printers, Los Angeles. Phone MA. 6-9171.

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I.

Preliminary Statement.

Whether viewed as a "mixed question of fact and law," and thus open for the Appellate Court's decision, or viewed as strictly a question of fact and thus posing the question whether or not the Trial Court's decision was "clearly erroneous," the issues in this case are fundamentally the same.

The District Court found that plaintiff well knew the transactions offered him violated the rules of the New York Stock Exchange. As will be discussed in paragraph II A and C below, this rendered the transactions illegal, and, in itself warrants reversal. The Court also found (and the plaintiff himself testified) that the transaction was unusual, and the agreed facts show that the transaction offered plaintiff a bonus or benefit not required by contract and committed defendant to a

guarantee of the performance of others. The factor of illegality and these other undisputed facts make the finding of ostensible authority and the imposition of liability upon Appellants erroneous.

The basic issues are: given the finding of plaintiff's actual knowledge that the transactions violated Exchange rules, given the additional facts that they were not usual transactions, that they involved a bonus or benefit not required by contract, and a guarantee by appellants of the performance of others, and that appellants did not give any specific indication that the particular transactions were authorized, could ostensible authority for those transactions be inferred from the positions occupied by Ross and Grossinger, and could liability be imposed upon Appellants for their acts in any event, in light of the District Court's findings.

Appellee's Brief relies on two incorrect assumptions, which may somewhat confuse the issues. These are:

(1) that the transactions offered plaintiff by Ross and Grossinger were "reciprocal business" and

(2) that Ross and Grossinger had actual authority to offer such transactions if the stock involved had been legitimate.

These assumptions should be dealt with at the outset, because they can be seriously misleading.

Dealing with the first argument first, the transactions offered plaintiff were not "reciprocal business," despite Appellee's repeated references to them as such.

"Reciprocal business," as the name implies, is the practice of New York Stock Exchange member firms ("member firms") of referring orders from a customer to buy *or* sell an unlisted stock to a non-member firm

who has referred listed stock business to it, thus enabling the non-member firm to find a buyer (or a seller, as the case may be) for the customer, and to earn a commission on the sale.

When the non-member firm takes on such referred commission business (*e.g.*, an order to buy stock) for a customer, it of course undertakes various legal obligations to the customer, such as the duty to exercise due care in promptly locating a seller at the lowest available price, as well as the various other duties that flow from such a fiduciary relationship. Even if the non-member firm should offer to purchase the stock itself, it takes the burden and risk of finding another buyer at a profit.

Plaintiff argues that buyers are available on the regional exchanges, but very often this is not the case, and, particularly with an over-the-counter stock, the search for a buyer or a seller can be very difficult indeed. Even on an exchange, prices fluctuate, and a buyer at the right price may not be available. Plaintiff himself testified that very often the problem of finding a buyer or seller is a difficult and complex matter [Tr. pp. 80-81]. But even in those cases where finding a buyer or a seller may prove less difficult, serious obligations and liabilities have been undertaken by the broker to the client in question. For rendering these services and for fulfilling these obligations, the non-member brokerage firm receives a commission. A referral to a non-member firm of such commission business or of such an order to buy or sell is called "reciprocal business" or sometimes "give-up business." This is the manner in which such business was described at the trial and the manner in which it is referred to in the SEC Report, which was not introduced or offered at the trial, but which Appellee has appended to his Brief.

The transactions offered plaintiff by Ross and Grossinger were not reciprocal business. They were fundamentally and clearly of a different nature. The distinction was plainly made at the trial [Tr. pp. 373, 377, 390-391]. The District Court did not find that referring any form of "reciprocal business" violated the Stock Exchange rules, as appellee suggests (App. Br. p. 8), but found only that the fixed-profit rebate transactions given to plaintiff (a wholly different thing) violated those rules, and that this fact was well known to plaintiff at the time he entered into these transactions.

Ross did not refer to plaintiff a customer who wanted to buy (or sell) an unlisted stock, so that plaintiff might, acting for that customer, find a seller (or buyer) and thus earn a commission. Ross gave plaintiff the name of a seller at one price and, at the same time, the name of a buyer at a higher price, and guaranteed both ends of the transaction, thus creating a fixed, guaranteed and wholly unearned profit, which plaintiff merely had to collect. Plaintiff did not have to find a buyer or a seller, or take any risk at all, or undertake at any time to act for anyone else or assume any obligations or liabilities, which flow from such an undertaking. All he had to do was act for himself in collecting the prearranged profit and thus realize his rebate. As plaintiff testified, Ross simply gave him the profit in exchange for his listed business [Tr. 140].

The giving of such an arranged profit is no different from plaintiff's receiving cash or a car in exchange for

giving his listed business to defendant. It is plainly a rebate and cannot be likened to the referring of commissioned business, commonly called "reciprocal business". Plaintiff himself was aware of the distinction when he accepted the arranged profit transactions. He knew and testified that such transactions were not "usual" [Tr. pp. 97-98]. He certainly knew of no broker penalized for referring "reciprocal business", yet he testified that, at the time he accepted the transactions in issue, he specifically knew of one suspended for becoming involved in the type of transaction offered by Ross and Grossinger [Tr. pp. 98-100].

Even in Appellee's Brief it is conceded that "Of course a transaction arranged solely for the purpose of giving a profit to an over-the-counter broker-dealer violates the rebate rule." (App. Br. pp. 28-29). Yet, the referral of "reciprocal business" is not such a violation, according to the SEC Report appended to Appellee's Brief.

Nevertheless, over and over again, Appellee's Brief refers to these arranged profit transactions as "reciprocal business." There is nothing in the SEC Report or in evidence that supports this designation in any way, and it is important to a correct analysis of the case that this semantic error be avoided. Otherwise, it is easy to succumb to the erroneous logic of Appellee's position: that the transactions here were "reciprocal business," that the referral of reciprocal business is common, and, *ergo*, that the transaction here was a common one.

The transaction here was not reciprocal business and was not usual. Moreover, it was a plain violation of the Exchange rules and found to be such by the Court. Defendant well knew this, as the Court also specifically found.

The fallacy in calling these transactions "reciprocal business" carries over into Appellee's second assumption which is equally incorrect. Thus, Appellee reasons that Ross and Grossinger must have had actual authority to refer legitimate "reciprocal business" to non-member firms, and, therefore, that plaintiff cannot avoid liability because (unknown to plaintiff) the stock involved here was not "legitimate" (see Appellee's Br. pp. 21, 29). But this argument leaves out a logical step which plaintiff cannot take—that the transactions in issue are "reciprocal business" and therefore would be authorized if the offered stock were legitimate. It also wholly misconceives our position. The basis of our contention that the transactions were unauthorized is not that the Jerome Richards stock was fraudulent. Our position is that the arranged-profit transactions, *even in legitimate stock,* were unauthorized, because they violated the New York Stock Exchange rules. If Ross gave plaintiff such an arranged profit transaction in General Motors stock, it would be just as much a violation of the Exchange rules, and equally unauthorized.

This is not a situation where an agent has authority to offer a particular transaction if the stock is valid, and thus, the principal cannot escape liability if the agent offers that transaction with invalid stock. Here the arranged-profit transaction itself is beyond the scope of the agent's actual authority, whether or not the stock

used to create the artificial profit is valid or fraudulent. The lack of authority does not come from the fact that the stock of Jerome Richards was valueless and fraudulent, but from the fact that the type of fixed-profit transaction violated the Stock Exchange rules, even if the stock had been legitimate and with a value as impliedly represented.

Here again, the flaw in plaintiff's logic comes from calling the transactions "reciprocal business," which plainly they are not, and reasoning from that label that, accordingly, they must have been actually authorized if the stock to be traded was legitimate.

Once these two incorrect assumptions are eliminated, the fundamental issues can squarely be faced. Where an agent has no actual authority to offer a transaction, the principal neither knows nor has reason to know of the offer, and the plaintiff (a professional broker of long experience) knows the transaction violates the rules of the Stock Exchange of which the principal is a member, knows that the transaction is an unusual one and that it involves a bonus or benefit to him not required by contract and a guarantee by the principal of the performance of others, can ostensible authority of the agent to make the offer, and to make representations in connection with the offer, be inferred from the agent's position and, in any event, can liability for those misrepresentations be imposed upon the innocent principal.

Under the rules of law set out below, whether this issue is analyzed as a question of fact or of law, or of mixed fact and law, the answer is no.

II.

Whether or Not the Finding of Ostensible Authority Is Within Rule 52(a), the Judgment Should Be Reversed.

In our Opening Brief, we tried to show that an issue such as the existence of apparent authority could be a question of fact for one purpose and under one set of circumstances, and yet be primarily a conclusion of law for another purpose or in other circumstances, and that it was not accurate or helpful to label a particular issue one of "fact" or "law" for all purposes and without regard to the circumstances or how or in what court the issue arose.

Thus, we cited cases showing that a particular issue could be considered a question of fact for state court purposes and yet be deemed one of law for purposes of federal appellate review (App. Op. Br. pp. 11-12) and that, even in the same jurisdiction, a particular issue could sometimes be treated as one of fact and sometimes one of law (App. Op. Br. p. 13).

We cited cases indicating that the fundamental test is whether the issue in the particular case is one dealing essentially with "the effect of certain transactions or events" rather than the "resolution of disputed facts." (App. Op. Br. pp. 10-14).

Appellee has cited other cases, describing the test as turning on whether resolution of the particular issue requires "experience with the mainsprings of human conduct" (App. Br. pp. 15-16).

Appellee has also cited cases, both in the State Courts and in the Fifth Circuit, labeling the question of ostensible authority one of "fact." However, analysis of these

decisions reveals that the trial court could not determine the issue of ostensible authority without resolving conflicts in the evidence, and that reversal on appeal would involve the appellate court in these disputed factual areas.

Our case is quite different. Even plaintiff agrees that most of the facts relating to the issue of ostensible authority are undisputed. But, even beyond that, the basic facts which call for a reversal of the judgment were actually found by the District Court. Thus, the trial judge found that plaintiff well knew the transactions he was offered violated the rules of the New York Stock Exchange and that the transaction was an unusual one. These facts found by the District Court, standing alone, call for a reversal of the judgment as do other undisputed facts in the record to which we will refer below.

The question of ostensible authority in this case did not involve the resolution of disputed facts, but called for a determination of the legal effect of those facts that were agreed upon and found by the Trial Court. Having in mind those facts, the Court had to apply a legal standard to decide if there was "ostensible authority." In making that determination, the Court applied an erroneous standard. Thus, the findings demonstrate that the District Court felt:

(1) that the fact that plaintiff knew the transactions violated the Stock Exchange rules did not render them illegal *as to plaintiff,*

and

(2) that if the transactions were not illegal *as to plaintiff,* they would not prevent ostensible authority.

The application of such standards does not involve experience with the "mainsprings of human conduct." It would be different if the Court had found that plaintiff believed the transactions in issue did *not* violate the Exchange rules and that plaintiff was reasonable in that belief. Such findings would involve an evaluation of the witnesses' testimony and would certainly require "experience with the mainsprings of human conduct," but this was not the case. The Trial Court found that plaintiff *did* know that the tansactions violated the rules, and the issue now is as to the legal effect of that determination and as to whether the Court was applying incorrect legal standards.

This being so, the conclusion of ostensible authority in our case should not be considered within the "clearly erroneous" rule of Federal Rule 52(a).

However, even if the case were deemed one within that rule, it would be one which calls for reversal, in that, taking the facts as found by the District Court the finding on the question of ostensible authority was clearly erroneous and, in any event, the imposition of liability upon appellants for the acts of their agents was incorrect as a matter of law.

A. On the Facts as Found by the Trial Court, There Could Be No Proper Inference of Ostensible Authority.

It is a fundamental rule of agency law that one who deals with a person he knows to be an agent has the duty to ascertain the scope of the agent's authority, and must bear the risk that the transaction is unauthorized if he does not fulfill that duty of inquiry.

Ernst v. Searle, 218 Cal. 233, 240 (1933);

Torrance N. Bank v. Evesco F. Credit Union, 134 Cal. App. 2d 316, 324 (1955);

LaMalfa v. Piombo Bros., 70 Cal. App. 2d 840, 844 (1945).

Thus, *in Ernst v. Searle, supra*, the California Supreme Court stated:

"A third person, such as appellant, is not compelled to deal with an agent, but if he does so, he must take the risk. He takes the risk not only of ascertaining whether the person with whom he is dealing is the agent, but also of ascertaining the scope of his powers. The rule is cogently stated in 1 Mechem on Agency, second edition, section 743, page 527, as follows: 'An assumption of authority to act as agent for another of itself challenges inquiry. Like a railroad crossing, it should be in itself a sign of danger and suggest the duty to 'stop, look and listen.' It is therefore declared to be a fundamental rule, never to be lost sight of and not easily to be over-estimated, that persons dealing with an assumed agent, whether the assumed agency be a general or special one, are bound at their peril, if they would hold the principal, to ascertain not only the fact of the agency but the nature and extent of the authority, and in case either is controverted, the burden of proof is upon them to establish it.' " 218 Cal. 233, 240 (1933).

The doctrine of apparent authority is not inconsistent with this rule. If the principal indicates to the third party that the agent is authorized to enter into a particular transaction, the third party has fulfilled his duty to inquire, and the principal will be liable, even if he

has secretly instructed the agent not to enter into such a transaction.

Where there is a specific indication from the principal to the third party that the agent is authorized to engage in a particular act, there is no problem in finding ostensible authority, and, thus, finding that the third party has satisfied his duty of inquiry. Where the difficulty arises is in situations like the instant case, where the principal does not indicate that the *particular* transaction is authorized, and the argument for his liability is based upon the assertion that he has placed the agent in a position from which apparent authority to enter into the particular transaction could be inferred.

This is the situation in our case. There is no evidence that Mr. Kamen specifically indicated to the plaintiff in any way that Ross and Grossinger were authorized to enter into the particular transactions in issue. The contention that there is apparent authority is founded essentially upon the fact that he permitted Ross to issue a card saying he was manager of Kamen's broker-dealer department and thus created the impression in plaintiff that Ross could do the things such a manager could do.

In such situations, the authority or apparent authority to enter into the particular transaction must be inferred from the general position of the agent. The scope of the agent's apparent authority is determined in the same way as that of his actual authority, excpt that it is measured from the point of view of the third party, rather than from the point of view of the agent.

Restatement of Agency 2d, Section 49.

Thus the question becomes, in light of the third party's knowledge (or the facts he had reason to know),

could authority for the particular transaction be reasonably inferred from the agent's position.

In deciding what sort of authority or apparent authority can be inferred from the general position of an agent, the Courts have formulated fundamental rules, several of which are applicable in this case.

The basic rule is that the third party may properly infer that the agent has authority to do everything *usual* and proper to fulfill his position.

> California Civil Code, Section 2319;
>
> Restatement of Agency 2d, Section 73, comment (b).

Under this rule, if the transaction is an unusual one, apparent authority or actual authority will not be inferred from the general position of the agent, even if he is a manager.

(Restatement of Agency 2d, Section 73, Comment (b)).

As the Restatement puts it, "any substantial departure from the usual methods of conducting business is ordinarily a sufficient warning of lack of authorization."

> Restatement of Agency 2d, Section 166, Comment.

Of course, liability for an unusual transaction may be created by a specific grant of authority or a specific statement by the principal that the particular act is authorized, despite the fact that it is unusual, but there is no such evidence in the record in our case.

As to whether the transactions in issue were "usual", the plaintiff admitted and the District Court specifically

found that they were "unusual" [Tr. pp. 97-98; Find. 35], and there is no question but that this was plain from the balance of the record [*e.g.*, Tr. pp. 135, 374, 390-391].

But there are even more specific rules which prevent an inference of ostensible authority in our case.

The most significant of these rules to our case is that, in the absence of extraordinary facts, such as a specific statement by the principal that the agent is authorized to enter into the particular transaction, authority or apparent authority to enter into an illegal transaction will not be inferred.

Restatement of Agency 2d, Section 34(d), Comment (g);

Call v. Palmer, 116 U.S. 98, 102, 29 L. Ed. 559, 561 (1885);

Shotkin v. Mutual Benefit Ass'n, 138 F. 2d 531, 533 (2d Cir. 1943);

California C. P. Growers v. Harris, 91 Cal. App. 654, 659 (1928);

Eckstein v. Eckstein, 49 N.Y.S. 2d 726* (1944);

Smith v. Southwestern Bell Tel. Co., 349 P. 2d 646 (Okla. 1960);

Rogers v. First State Bk. of Aguilar, 79 Colo. 84, 243 Pac. 637, 639 (1926);

See

California Highway Commission v. Reily, 192 Cal. 97, 107 (1923);

Nuffer v. Ins. Co. of No. America, 236 A.C.A. 372 (1965).

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*The *Eckstein* case is miscited at p. 29 of our Opening Brief.

This is not to say there cannot be a case in which the principal gives actual authority for an illegal transaction or in which the principal specifically indicates to a third party that his agent is authorized to enter into such a transaction, even if he has secretly instructed the agent not to do so. The rule above cited extends only to the question (fundamental to our case) of whether authority to enter into an illegal transaction can be inferred from the general position of the agent, and the courts have uniformly held that it cannot.

In our case, the District Court has specifically found that the plaintiff well knew that the fixed-profit transactions offered him by Ross and Grossinger were in violation of the rules of the New York Stock Exchange, of which defendant was a member [Find. 35].

Appellee argues that the rules of the Stock Exchange are not "law" and therefore the transactions were not "illegal." The District Court apparently acted under the same misimpression in making its findings that, despite the fact plaintiff knew the transactions offered violated the Stock Exchange Rules, they were not "illegal insofar as the plaintiff's participation therein was concerned" [Find. 35].

However, both of these positions misconceive the law. Admittedly the Stock Exchange Rules are not statutes (although they are authorized by statute and controlled by a statutory commission) and their violation is not a crime (although it does lead to severe administrative penalties). But this does not mean that an agreement known to be in violation of the rules is not illegal. In fact, it is one of the classic examples of illegality.

> *Restatement of Contracts,* Section 576, illustration 3.

Rules of the Stock Exchange not only provide regulation of Exchange procedures and the activities of the Exchange members, essential to the public interest,* but constitute a contract between the members of the Exchange.

E.g.,

Roberts v. Criss, 266 Fed. 296, 300-301 (2d Cir. 1920).

Contrary to the rule applied by the District Court, an agreement which calls for one of the parties to breach his contract with a third party is an illegal agreement.

Restatement of Contracts, Section 576.

E.g.,

Roberts v. Criss, supra, at pages 301, 302;

Reiner v. No. American Newspaper Alliance, 259 N.Y. 250, 252 (1932).

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*The Exchange Rules are sanctioned by the Securities and Exchange Act of 1934, and are vital to carrying out the aims of self-regulation intended by Congress in enacting that legislation. See:

Silver v. New York Stock Exchange, 373 U.S. 341, 352-356, 10 L. Ed. 2d 389, 397-399, 83 S. Ct. 1246 (1963).

The answer to plaintiff's suggestion that the commission fixing rules may be a violation of the anti-trust laws, is that the 1934 Act expressly sanctions Exchange Rules fixing commission rates and gives the SEC the power to review and alter such rules. 15 USC Section 78s(b); See *Pan American Airways v. United States,* 371 US 296, 298, 9 L. Ed. 2d 325, 328, 83 S. Ct. 476 (1963). The *Silver* case, *supra,* which plaintiff cites for the proposition that the commission rule may be invalid, fails to support that proposition at all. In that case, the Supreme Court held that the particular method of enforcement of another exchange rule exceeded the authority of the Exchange under the 1934 Act and, therefore, was subject to the anti-trust laws. 373 US 341, 364-365, 10 L. Ed. 2d 389, 404.

Thus, Section 576 of the Restatement provides:

> "A bargain, the making or performance of which involves breach of a contract with a third person, is illegal.
>
> Comment:
>
> a. Since breach of contract is a legal wrong, a bargain that requires for its performance breach of a contract with another, is opposed to public policy."

Strikingly enough, one of the Restatement's specific illustrations of this type of illegality is an agreement under which one of the parties will be called upon to violate a stock exchange rule (in fact the rule violated in our case). Thus, the illustrations to Section 576 include the following example of illegality:

> "Illustrations: . . .
>
> 3. A. bargains with B., a member of a stock exchange, to give B. stock brokerage business in consideration of B.'s charging reduced commissions in violation of the rules of the Stock Exchange, by which B. had agreed to be bound when he became a member. *The agreement is illegal.*" (Emphasis added).
>
> *Restatement of Contracts,* Section 576, illustration 3.

A specific decision to this effect, and one of the leading cases in the field, is *Roberts v. Criss,* cited above, 266 Fed. 296, 300-302 (1920). In that case the contract in issue was one which would have caused one of the parties to violate the Stock Exchange Rules. The

court held the contract illegal, analyzing the nature of the rules and the contractual rights of the other exchange members which require that such agreements be unenforceable.

A similar case, and one which specifically deals with the authority of an agent to enter into such a transaction, is *California C. P. Growers v. Harris,* 91 Cal. App. 654, 659 (1928). That case dealt not with the violation of a stock exchange agreement but with the analogous situation of a cooperative marketing agreement among fruit growers, under which the growers agreed with a growers association that each would sell its peach crop to the Association. The Association sued the defendant for selling his crop elsewhere, and the defendant's argument was that a general agent of the association advised him that the Association would not buy his peaches. The Trial Court, apparently believing that there had been such a conversation, held for the defendant. The judgment was reversed on appeal on the theory that any arrangement between the agent and the grower under which the grower would sell his crop elsewhere, would constitute a breach of the cooperative marketing agreement and violate the rights of the other growers and, accordingly, that the Court could not infer that the agent had authority to so act.

Since, in our case, the Court found that plaintiff well knew the transactions offered by Ross and Grossinger violated the Stock Exchange rules and since, under the authorities cited above, this rendered those transactions illegal, authority on the part of Ross and Grossinger to enter into such transactions cannot be inferred from their positions as general agents, but could only be based

upon a specific authorization from plaintiff or a specific statement from defendant to plaintiff that this particular type of transaction was authorized.* Of course there was no specific grant of authority, nor was there any such specific indication from defendant that this particular type of transaction was authorized.

Accordingly, taking the facts as found by the District Court, the inference of ostensible authority was based upon the application of an erroneous legal standard, could not properly be drawn and should be reversed.

Even beyond the rule that ostensible authority will be inferred from an agent's position only where the transaction is usual and proper, and the rule that it will not be inferred from the agent's position if the transaction is illegal, there are other such rules which render the inference of ostensible authority improper in this case. For example, authority to render a bonus or benefit to a third party not required by law or contract will not be inferred from the general position of the agent, even if the bonus might indirectly bring benefit to the principal.

1 Mechem, *Agency*, page 707.

E.g.,

Harbor Const. Co. v. Walters, 101 Cal. App. 470, 474 (1929) [Manager has no authority to waive contract rights];

Union Pacific Town-site Co. v. Page, 54 Kans. 363, 367 (1894) [Development company's

*Even if the transactions in issue were not described as "illegal," but only in violation of the Exchange Rules, the result should be the same. Surely, a third party dealing with an agent cannot reasonably infer from his general position that the agent has authority to enter into a transaction which the third party knows will place the principal in breach of contract and subject him to severe administrative penalties.

agent has no authority to pay for lumber for lot buyer];

Brenard Mfg. Co. v. Sketchley Store, 185 Iowa 694, 699 (1919) [Store manager has no authority to acquire jewelry to give away to customers];

Flowers v. Bush and Witherspoon Co., 254 Fed. 519, 521, 522 (5th Cir. 1918) [General agent has no authority to cancel contract gratuitously].

See

Howard v. Winton Co., 199 Cal. 374, 379 (1926).

In our case, plaintiff was plainly receiving a bonus or benefit not required by law or contract, when he was offered the pre-arranged-profit transactions by Ross and Grossinger. Under the cases, even without the factor of illegality, the authority of the agent to give plaintiff such an unrequired benefit could not be inferred from his position as manager of the broker-dealer department, and, again, there is not a scintilla of evidence that defendant Kamen specifically indicated in any way to plaintiff that this particular type of arranged-benefit transaction was authorized.

A fourth rule which also renders the inference of ostensible authority improper is that authority to issue a guaranty or to make the principal liable for the performance of a third party will not be inferred from the general position of an agent unless the transaction is indispensable to the performance of his duties.

1 Mechem, *Agency,* pages 712-713, 724.

E.g.,

Zellerbach Paper Co. v. Virden Pkg. Co., 10 Cal. App. 2d 635, 640 (1935);

First Nat'l Bank v. Farson, 226 N.Y. 218, 224, 123 N.E. 90 (1919);

In re Union City Milk Co., 329 Mich. 506, 310 (1951);

Restatement of Agency 2d, Section 73, Comment (b) illustration 7.

In our case, seller's performance, the buyer's performance and, thus, the entire arranged profit, was guaranteed by the principal, Kamen & Co., bringing the case squarely within this rule and again rendering the inference of ostensible authority improper.

We have cited four rules of law which call for a reversal of the inference of ostensible authority, in light of the fact that defendant never indicated that the fixed profit transactions were specifically authorized: (1) the rule that such authority will not be inferred unless the transaction is a usual one; (2) the rule that such authority will not be inferred if the transaction is illegal; (3) the rule that such authority will not be inferred if the transaction confers a bonus or benefit not required by contract; and (4) the rule that such authority to make the principal responsible for the performance of a third party will not be inferred unless indispensable to proper performance of the agent's duties. Each of these rules would call for a reversal of the conclusion of ostensible authority.

In our case all four rules apply. The transaction was admitted by plaintiff and found by the Court to be an unusual one, although the Court, apparently placing

upon the plaintiff a far lighter burden than required by the authorities, added in its findings that it was not "so unusual or shocking" as to put the plaintiff on notice. Aside from its being unusual, the transaction was an illegal one. In addition, it plainly conferred upon plaintiff a bonus or benefit not required by law or contract and bound defendant to a guarantee of the performance of others.

Accordingly, under the authorities we have discussed, whether the inference of ostensible authority is deemed a finding of fact or a conclusion of law, it should be reversed.

Appellee cites Restatement Section 231 to the effect that the principal may be liable even for illegal or tortious acts of the agent (App. Br. p. 37). Of course this is so, but not where the plaintiff has reason to know the transaction is illegal or tortious and where there is no indication of specific authority from the principal for the particular transaction.

Plaintiff argues "the fact that Appellee did not have a previous similar transaction is totally irrelevant" (App. Br. p. 29, n. 9). But this does not accord with the law of California. Not only does this fact support the finding that the transaction was "unusual," but in this state, the cases have held that where a third party seeks to rely upon the ostensible authority of an agent, he must produce evidence that at least one similar transaction on the part of the agent has been actually authorized or ratified by the principal.

E.g.,

Credit Bureau of San Diego v. Beach, 144 Cal. App. 2d 439, 444 (1956).

See

2 Cal. Jur. 2d 700.

In response to the argument that plaintiff could have prevented the loss by a simple inquiry into the scope of Ross and Grossinger's authority, plaintiff argues that he did check with the "owner", in that Ross was the manager of the broker-dealer department and represented the owner (App. Br. p. 21, n. 6). But this reasoning is patently circular. Plaintiff knew that, regardless of his title as manager of the broker-dealer department, Ross was a mere agent, and he could not fulfill a duty to ascertain the scope of the agent's authority by talking to the agent himself. It would have been a simple matter to check with Mr. Kamen, in which event he would have been advised that such transactions were wholly unauthorized and the entire loss would have been prevented.

Plaintiff points out that defendant Kamen & Co. has received and retained gross commissions of $166. on the listed business referred to it by plaintiff. But it should be noted that, as was found by the District Court, these were commissions on the handling by Kamen & Co. of sales of legitimate listed securities for plaintiff's customers and did not in any way involve the trading of Jerome Richards stock [Find. 20]. There is no evidence of any demand or request by any of these customers for rescission or cancellation of these legitimate, listed-stock sales or for return of the commissions paid by them to Kamen & Co. As the District Court also found, Kamen & Co. was at no time involved in trading of the stock of Jerome Richards & Co. and it earned no commissions whatsoever on such Jerome Richards trading. In light of these facts, the fact that plaintiff earned and retained commissions on the legitimate listed stocks traded by customers referred by plaintiff has no legal significance. If Kamen & Co. had earned commissions

on plaintiff's Jerome Richards transactions and, despite a demand for return of those commissions by plaintiff, retained those benefits, it is possible that plaintiff could mount an argument that this conduct amounted to a ratification of the fraud. But the facts in our case warrant no such argument.

Plaintiff argues that the SEC Report appended to his Brief discusses forms of reciprocal business referred by New York Stock Exchange member firms to non-member firms which involve "fixed profits." But, an examination of the SEC Report reveals that it is dealing with the practice of referring commission business to non-member firms; and, even if the commissions earned are, in a sense, "fixed," the referring of such business is nothing like the granting of a guaranteed-profit arrangement in order to direct a cash rebate into plaintiff's hand. The distinctions are manifest and are discussed in paragraph I. above.

Even the compensation techniques which the SEC Report relates are employed by mutual funds, and which, since they are not rebates by New York Stock Exchange members, do not apply here in any event, do not extend to such blatant rebating as occurred here.

Plaintiff contends that when he filled out the forms to receive his guaranteed profit he rendered "execution and clearance services" which he presumably contends take his case out of the category of a rebate (App. Br. p. 3). But the execution and clearance services rendered by a stock broker in earning a commission, which involve the responsibility of acting for the customer, with its corresponding obligations and liabilities, cannot reasonably be compared to the ministerial paperwork done by plaintiff for his own account to collect his arranged

profit. There is nothing in the SEC Report at the page cited by plaintiff (App. Br. p. 3) or anywhere else, that indicates that what plaintiff did in this case could be construed as rendering "execution and clearance services." Plaintiff might just as well argue, if he had been given a rebate in the form of a cashier's check, that by endorsing the check, making out a deposit slip and mailing these documents to his bank he rendered "execution and clearing services" and thus took his cash payment out of the category of a rebate.

Appellee argues that when Kamen & Co. acts for its own customers, it does no more than plaintiff did to collect his arranged profit given by Ross and Grossinger. This is the same argument again. Kamen & Co., like any other broker, acting for a customer to earn a commission, renders services and undertakes serious liabilities to earn its fee. Frequently, even before there is a purchase or sale, such a broker is called upon to analyze the securities in question, or many other securities, and to give advice, counseling and recommendations to the potential customer. If those recommendations are negligently given, or the analysis negligently made, there is serious liability. Once there is to be a sale, if the customer is a seller, the broker must promptly record the order and have his man on the Exchange floor locate a buyer (or vice versa) and must see that the sale is promptly consummated. If the broker is not prompt in carrying out the order, he may be liable to the customer for substantial damages. The broker may receive an order to sell or to buy at a specific price, in which event he must be alert to any moment at which that price is reached, or, again, he may be liable. The broker may retain a clearing firm, instead of employees for certain of its

services, or it may use both a clearing firm and its own men on the floor of the Exchange, as Kamen & Co. did [Tr. pp. 257, 276], but its liability is the same. The clearing firm fulfills only a few of the foregoing functions [Tr. p. 257]. The basic responsibility is still that of the fiduciary broker.

Such a situation cannot reasonably be compared with plaintiff being given the name of a buyer at $19.00 per share and the name of a seller at $19.50 per share and told that all he has to do is pocket the difference, with both ends guaranteed by Kamen & Co. Such a transaction is obviously just a poorly disguised cash bonus, and the statement that its receipt is no different from Kamen & Co.'s normal activities in serving its customers for a commission just does not stand up to analysis.

No matter how much plaintiff may protest that what he took from Ross and Grossinger was just the same as an ordinary referred-commission business, and no matter how frequently he may label these rebate transactions as "reciprocal business," the facts will not support such conclusions. In any event, the Trial Court in its findings did not accept plaintiff's position in this regard. It plainly and unequivocally found that plaintiff well knew that the transactions he received violated the New York Stock Exchange rules. This being so, and there having been no evidence of any specific indication from defendant to plaintiff that the particular transactions were authorized, there can be no ostensible authority.

Plaintiff relies in his Brief upon ostensible authority cases which we have previously cited and distinguished. It is plain, and we concede, that slight or technical dif-

ferences from normal procedures will not necessarily remove a transaction from the scope of an agent's apparent authority—particularly where the third party dealing with the agent is a layman and one of limited knowledge. Thus, the minor procedural differences from the norm in *Walsh v. Hooker & Faye,* 212 Cal. App. 2d 450, 454 (1963) (App. Br. p. 34) and *Blackburn v. Witter,* 201 Cal. App. 2d 518, 521 (1962) (App. Br. pp. 34-35) [which cases are discussed and distinguished in our Opening Brief at pages 24 through 26], can hardly be compared with the flagrant rebate scheme offered in our case to a professional dealer of long experience and known by him to be in violation of the Exchange rules and to involve an unrequired bonus or benefit and a guarantee by the principal . . . all factors which do not appear in the cases cited by plaintiff.

Similarly, in *Ghiglioni v. American Trust Co.,* 49 Cal. App. 2d 633, 637 (App. Br. p. 35) there was no indication that the plaintiff (an elderly immigrant who could barely read English) had reason to know that the transactions offered him were unusual or improper.

No case cited by plaintiff permits an inference of apparent authority for a transaction known to the plaintiff to be illegal (or, if plaintiff prefers, known to put the principal in breach of a contract with a third party and likely to subject him to severe penalties), or for a transaction giving plaintiff the principal's guarantee of the performance of another party where that is not indispensable to the agent's function, or for a transaction which involves a bonus or benefit not required by law or contract; and certainly no case finds apparent authority where all such factors coincide.

Accordingly, whether deemed a finding of fact or a conclusion of law, the Court's inference of ostensible authority cannot be a correct one, in light of its findings of fact, and that conclusion, and the judgment based thereupon, should be reversed.

B. Appellants Are Not Liable Under Other Agency Doctrines.

Appellee's Brief refers to other agency doctrines which he contends support liability even if there is no ostensible authority and despite any reason on plaintiff's part to doubt the authority of Ross and Grossinger.

Thus plaintiff argues that *whether or not he had reason to doubt the agents' authority,* appellants are liable if (1) Ross and Grossinger were "servants" and the transaction was within the "scope of their employment," or (2) if it was within their "agency powers" or (3) within the scope of appellants' "non-delegable duties."

But no such terminology alters the basic issues in the case or frees plaintiffs from the rule (basically restating the test of ostensible authority) that the plaintiff may not recover if, in light of the facts known to him, or which he should have known, he could not reasonably infer authoriy for the particular transaction. As analyzed in paragraph A. above, on the facts found by the Trial Court, plaintiff could not properly draw such an inference.

1. *Scope of servants' employment.* In the instance of non-transactional torts, such an assault or negligent physical injury, which are not based upon dealings between the agent and the plaintiff and where the plaintiff's state of mind as to the authority of the agent is irrelevant, liability is founded upon the fact that the

agent was a "servant" and was acting within the "scope of his employment" (Restatement of Agency [2d], Section 219).

But these standards have no application to the determination of authority to make misrepresentations in dealings with the plaintiff, a situation in which the plaintiff's state of mind is of the essence. Thus, the Restatement has set up special rules for determining authority in fraud cases, which make it clear that, in such cases, no distinction is made between "servants" or other agents, that the "scope of employment" is not a significant test and that, in any event, there can be no liability where the third party could not reasonably believe the agent was authorized.

Thus, Section 249 of the Restatement, in dealing with liability for misrepresentations, discards the distinctions applied in dealings with non-transactional torts, and provides:

> "A master is subject to liability for the misrepresentations of a servant causing pecuniary loss as he is for the misrepresentations of an agent who is not a servant.
>
> Comment:
>
> a. A detailed statement of the liability of a master or other principal for the misrepresentations of agents which causes pecuniary harm is made in Sections 256-265. It is to be noted that in such situations the master or other principal may be liable for the acts of a servant or an apparent servant who acts wholly for his own purposes and hence is not acting in the scope of employment."

Referring then to the particular sections which deal with the liability of a principal for the misrepresenta-

tions of his agent (whether the agent is a servant or not, and whether or not the representations are within the scope of his employment) it is apparent that, in no event, can there be liability for such misrepresentations where the third party had reason to doubt the authority of the agent, or, put differently, where he could not reasonably infer that the agent was authorized to enter into the particular transaction. This is repeated at several places throughout the Restatement sections dealing with liability of the principal for fraud. Perhaps it is most clearly stated in Comment c. to Section 258, which provides as follows:

> "Comment"
>
> c. WHERE THIRD PERSON SHOULD KNOW THAT THE AGENT IS UNAUTHORIZED. *A principal is not liable in deceit for unauthorized representations made to a person who has reason to believe that they are not of the sort authorized.* If, therefore, the representations are of a sort which, in view of the nature of the agency, the article sold, and the purpose for which it is sold, normally would not be authorized, the other party has no action of deceit against the principal who did not authorize them. Likewise, if the representations are as to a matter concerning which the other party, in view of business customs and other facts which he knows or should know, should realize the agent is not authorized to make statements, the principal is not liable for them." (Emphasis added.)

This section would seem, in itself, to demonstrate that Appellee's position is incorrect.

To the same effect is Restatement Section 261, the language of which has been adopted in California in *Walsh v. Hooker and Faye,* 212 Cal. App. 2d 450, 454 (1963), at page 456, stating that in fraud cases, it is necessary to liability that: "from the point of view of the third person, the transaction seems regular on its face and the agent appears to be acting in the ordinary course of business confided to him." The same language is approved in *Rutherford v. Rideout Bank,* 11 Cal. 2d 479 (1938).

At pages 33 to 35 of his Brief, Appellee cites and discusses several cases which he evidently contends stand for the proposition that if the agent commits a fraud within the scope of his employment, the principal may be held liable even though the third person dealing with the agent had reason to doubt the agent's authority. But not one of these cases stands for that proposition. Included among the cases are *Blackburn v. Witter,* 201 Cal. App. 2d 518; *Walsh v. Hooker and Faye,* 212 Cal. App. 2d 450 and *Ghiglioni v. American Trust Company,* 49 Cal. App. 2d 633, already discussed at pages 24 through 26 of our Opening Brief and at page 27 of this Brief. These cases, as well as *Rutherford v. Rideout Bank,* 11 Cal. 2d 479, *J. C. Millet & Co. v. Park and Tilford Distillers Corp.,* 123 F. Supp. 485 and the majority of the other cases cited in this section by plaintiff, expressly turn on the *ostensible authority* of the agent and, thus that the third person dealing with the agent had no reason to doubt his authority. It is true that two of the cases cited by defendant, *Mitchell v. Union Pacific Railroad Co.,* 188 F. Supp. 869, 873 (S.D. Cal. 1960) and *Ralston Purina Co. v. Novac,* 111 F. 2d 631, 636 (8th Cir.

1940) use the term scope of "employment" rather than scope of "authority" or "ostensible authority" in discussing the reasons for the principal's liability. However, in those cases the transactions in question were plainly within the scope of the agent's ostensible authority, and there is not the slightest suggestion in either case, or in any of the authorities cited by plaintiff, that there would be liability if the third party dealing with the agent had reason to doubt his authority.

We have been able to find no case or other authority supporting that extreme contention. It is flatly contrary to the rules set out in the Restatement of Agency and clearly expressed in the California cases. Such a doctrine would be a harsh one indeed. It is difficult to see any reason why an innocent principal should be held liable in those situations in which the third person has reason to doubt the agent's authority, but proceeds with the transaction anyway, and the law does not support such a result.

2. *"Agency powers."* The use of the term "agency powers" does not add to plaintiff's right to recover, if plaintiff could not reasonably infer from the agent's position that he had authority to offer the transaction in question.

The term "agency powers" referes to a concept used in the Restatement where the principal places a general agent in a position, such as that of a manager, and where the third party gains a reasonable impression of the agent's authority not from any communication from the principal, but from the agent's position itself (see Restatement of Agency 2d, Section 161). Most cases would refer to this situation as a type of

ostensible authority, since the principal, in permitting the agent to call himself a manager, is really communicating to the third party that the agent has such authority as can reasonably be inferred from that position. The Restatement, however, separates the two situations.

In any event, however, whether the situation is described in terms of "ostensible authority" or "agency powers," it is clear that the third party dealing with the agent must reasonably be able to infer from the position of the agent that the particular transaction is authorized.

Restatement, Section 161, the section dealing with so-called "agency powers," makes it clear that the Restatement's "agency powers" terminology does not in any way eliminate the requirement that the third party must reasonably believe the agent was authorized. Thus the section expressly provides, as a condition to the principal's liability, that the third party "reasonably believes the agent is authorized and has no notice that he is not so authorized."

Whether Mr. Kamen's permitting Mr. Ross to describe himself as the "Manager of the Broker-Dealer Department" is considered an act giving Ross certain "ostensible authority" or is described as creating in Ross certain "agency powers," the issue is the same—that is, the scope of that authority or those powers that could be reasonably inferred by plaintiff from the fact that Ross occupied that position.

Under the cases discussed above, it could not be reasonably inferred that Ross had authority to offer the transactions in issue.

3. *"Non-delegable duties."* This rather limited doctrine was developed to prevent the use of independent contractors instead of employees as a means of avoiding liability for the torts of workmen within the authorized scope of their job. It is generally available where the defendant is in a business involving danger to the public and requiring a license as a prerequisite to doing business. The doctrine was not designed to expand the areas in which a principal would be responsible for the torts of his agent, and this is quite plainly pointed out in at least two of the cases cited by plaintiff.

See, *e.g.*,

> *Snyder v. So. Cal. Edison Co.*, 44 Cal. 2d 798, 799-801 (1955);
>
> *Taylor v. Oakland Scavenger Co.*, 17 Cal. 2d 594, 604 (1941);

Thus, in the *Taylor* case, the California Supreme Court analyzed the doctrine as follows:

> "An employer is generally liable for negligent acts of employee performed within the scope of employment, but if an independent contractor rather than master and servant relationship exists, the independent contractor usually is alone liable for his negligent acts. If, however, an individual or corporation undertakes to carry on an activity involving possible danger to the public under a license or franchise granted by public authority subject to certain obligations or liabilities imposed by the public authority, these liabilities may not be evaded by delegating performance to an independent contractor."

And in the *Snyder* case, *supra,* the court made it clear that the doctrine of nondelegable duties merely puts independent contractors in the same position as employees, where the public interest does not justify the distinction.

Thus, the doctrine of nondelegable duties adds nothing to our case. Defendant Kamen & Co. already had the duties of an employer with reference to the acts of its employees. It could already be liable, for example, for transactions within the scope of its employee's actual or apparent authority. The fact that Kamen & Co. is licensed is irrelevant here. The fact might only prevent Mr. Kamen from avoiding all liability by hiring an *independent contractor* to perform his duties. In such event, he would be just as liable for the independent contractor's actions as he would have been for his own employees. But the doctrine of nondelegable duties does not in any way increase or decrease the responsibility of Kamen & Co. for its employees, which turns upon their liability on the general agency principles discussed above.

Hudson v. Nixon, 57 Cal. 2d 482, 484, also cited by plaintiff as involving nondelegable duties, involves an act by a husband who was held to be acting as agent for his wife and was considered to have acted within the scope of his employment. The Opinion does not, at any point, mention, refer to or rely upon the doctrine of nondelegable duties. It does not involve misrepresentations or fraud, in any event, and falls within the ordinary non-transactional tort cases covered by Restatement Section 219.

C. Since the Transactions Were Illegal and the Misrepresentations Would Not Be Actionable if Made by Appellants, They Cannot Be Liable for Such Acts by Their Agents.

Ross and Grossinger, who were also defendants but are not appellants, have not defended this action, and the District Court has found that they defrauded the plaintiff by impliedly representing to him that there was a market for the stock of Jerome Richards & Co., thereby inducing him to enter into the transactions under which he simultaneously bought and sold that stock at a pre-arranged gain in violation of the Stock Exchange Rules [Finds. 17, 18].

The question we now face is whether Appellants who were found not to have been participants in the fraud or to have been negligent in permitting it to occur, can properly be held liable for that fraud on the part of their agent.

It seems apparent that Appellants could not be held liable for their agents misrepresentations, if liability could not be imposed upon them had they made such misrepresentations themselves.

Without question, the acts of Ross and Grossinger were reprehensible and nothing we say here should be taken to justify those acts. Nevertheless, the agreement into which plaintiff was led by their fraud was plainly illegal, in that it violated the rules of the New York Stock Exchange, as the District Court found plaintiff well knew.

It is the view of Professor Williston that one who is induced by fraudulent misrepresentations to enter into an illegal agreement may not seek redress in the

courts based upon the fraud, unless the fraud is the sort that prevented him from ascertaining the facts that made the transaction illegal.

> 5 Williston on Contracts (Rev. Ed.), Section 1791, pp. 5089-5091.

Thus, Williston distinguishes *Randall v. California Land Buyer's Synd.,* 217 Cal. 594 (1933), permitting rescission of an illegal agreement for fraud, where (unlike our case) the fraud prevented the plaintiff from learning the facts creating the illegality.

A New York case has specifically applied the rule advocated by Williston to an action for deceit, dismissing the plaintiff's complaint to recover damages for fraudulent misrepresentations which induced him to enter into an illegal gambling transaction.

> *Landley v. Fischer,* 235 N.Y.S. 368, 369, 266 App. Div. 352 (1929).

Wallace v. Opinham, 73 Cal. App. 2d 25 (1946) has applied the *Williston* rule to illegal contracts in California. The *Wallace* case has been cited with approval by the California Supreme Court in *Hamilton v. Abadjian,* 30 Cal. 2d 49, 52 (1947) and followed in *Beach v. Arblaster,* 194 Cal. App. 2d 145, 160 (1961).

Not every jurisdiction has entirely accepted the New York and California view on this issue. The United States Supreme Court, in *National Bank & L. Co. v. Petrie,* 189 U.S. 423, 47 L. Ed. 879, 23 S. Ct. 512 (1902), permitted rescission for fraud regardless of possible illegality. The case may be explained by the fact that the plaintiff there did not know of the facts giving rise to the possible illegality, and, in any event,

the Court pointed out that the transaction "might have been lawful" and was "not necessarily wrong." (47 L. Ed. 880). To the extent that the case would permit rescission for fraud inducing an illegal transaction, it is criticized by Williston (5 Williston on Contracts [Rev. Ed.] p. 5090), and, in any event, is not necessarily applicable to an action for damages for deceit, as opposed to one for restitution.

In *Berman v. Riverside Casino Corp.*, 323 F. 2d 977 (9th Cir. 1963), this Court cited the *Landley* case as the law of New York and the *Wallace* case as the law of California. but held Nevada law to be to the contrary, at least as to gambling transactions.

The dealings between plaintiff and Appellants took place by telephone between California and New York. In this Brief and in our Opening Brief, we have cited both New York and California cases as well as decisions from other jurisdictions. There appears to be no direct conflict between New York and California law, and it seems clear that the law of one of these two jurisdictions would apply.

Since the District Court found plaintiff well knew the transactions violated the rules of the Exchange and the fraud did not prevent him from knowing the facts causing the illegality, the case is not like the *Randall* case, *supra,* but seems squarely within the *Landley* and *Wallace* cases. Accordingly, under the rule advocated by Williston, which apparently is at least the law in New York and California, plaintiff could not have held Appellants liable for damages had they directly induced him to take the illegal transactions offered by Ross and Grossinger.

This being so, the Court erred in holding Appellants liable for such acts committed by their agents, even if these acts were within the scope of their ostensible authority.

Certainly, if a defendant *in pari delicto* with the plaintiff in an illegal transaction is not liable for making misrepresentations inducing that transaction, it is *a fortiori* that an innocent defendant cannot be held for such misrepresentations made by his agents.

III.

The Court Did Not Err in Finding That Appellants Were Not Negligent.

The District Court found that Kamen & Co. was neither fraudulent nor negligent, that it exercised due care in the selection and supervision of its employees, and that it neither knew nor had reason to know of the fraud being carried out by Ross and Grossinger [Find. 24].

Plaintiff challenges the Court's finding that Kamen & Co. was not negligent. This finding, however, is strongly supported by the evidence in the record.

The thrust of plaintiff's attack on the finding is that plaintiff should have known, from the greatly increased volume of business that resulted from the services of Ross and Grossinger, that they were involved in some sort of improper activity (App. Br. pp. 45, 46). But the record does not warrant this conclusion and strongly supports the position of the District Court.

A brief review of the testimony may be helpful in this regard. It should be borne in mind that the Jerome Richards trades were not recorded in documents sent

to or from Kamen & Co. in that Kamen & Co. was not a party to any such transaction. Evidently, the only dealings in connection with this stock affecting Kamen & Co. were telephonic.

Before Ross and Grossinger were hired, Kamen & Co. had had little, if any, "wholesale business," that is, listed stock business referred from non-member broker-dealers, as opposed to the business of Kamen & Co.'s own customers among the public [Tr. p. 272]. Ross and Grossinger told Mr. Kamen they had taken a travling survey of broker-dealers throughout the country with reference to the type of service that would be attractive to such non-member firms, and that, if Mr. Kamen would put in special telephone equipment and offer free telephone lines and fast service in obtaining quotes and placing orders, as well as free use of various research materials, and the right to call upon Loeb Rhodes' "40 specialists" for immediate and free stock information, the non-member firms would refer to Kamen & Co. listed business in great quantities, and Ross and Grossinger expected that this could generate up to $300,000 in gross commissions per year [Tr. pp. 245-247].

Mr. Kamen knew his own firm selected over-the-counter brokers for its customers on the basis of price and good service [Tr. p. 280], and he thought that broker-dealers would choose a member firm on the basis of service in the same manner. He knew that his firm, being small, and having its own man on the floor, could put through orders and get quotes faster than Loeb Rhodes and the other large firms [Tr. pp. 257, 276, 404, 405]. This was confirmed by the testimony of Mr. Cohon [Tr. p. 380]. Mr. Kamen also knew that the

Loeb Rhodes specialist service would be a valuable thing and believed that, if he could combine this with his faster action and free telephone service, Kamen & Co. would indeed be giving the broker-dealers an attractive package. There is nothing in this that appears in any way unreasonable, it was confirmed by the testimony of Mr. Cohon, an expert of high qualification, and evidently was accepted by the District Court. In fact, there is no evidence in the record that much of the large volume of wholesale business produced after Ross and Grossinger came to work did not, in fact, come from the better and quicker services the company now offered. Perhaps the Jerome Richards rebates produced some of this increased volume, but there is no indication from the evidence that they were wholly or even primarily responsible.

Mr. Cohon testified that the volume promised and actually produced in the "wholesale" field by Ross and Grossinger was by no means extraordinary or suspicious [Tr. pp. 378, 381]. His own firm, for example, even though it discourages listed business, refers such business to member firms in quantities in excess of $300,000 per year. By getting his account alone, Ross and Grossinger could have reached their projected volume. Mr. Cohon also pointed out that he chooses his listed firms solely on the basis of service [Tr. pp. 378-380].

Mr. Cohon testified that such wholesale business normally produces far greater volume than direct dealing with the public, but can be far less profitable because of the enormous expenses involved, and that without a volume of at least $200,000. or $300,000., whole-

sale business would not pay at all. This would not be the case with retail business where expenses and volume would be lower [Tr. pp. 381, 395, 397, 398].

While the large volume realized would have given Ross and Grossinger commissions in a higher amount than most registered representatives receive, Mr. Cohon testified he would not consider it suspicious or even unique in the wholesale field. He pointed out that experience as a broker has little to do with success in soliciting accounts, that his company had a salesman who had earned $90,000. in commissions his first year in retail business, and that it was much easier to reach such figures in wholesale business [Tr. pp. 379, 398, 399].

If Mr. Cohon's testimony on this issue was accepted by the Court, and evidently it was, Mr. Kamen was certainly reasonable in believing Ross and Grossinger's statements and in seeing nothing suspicious in the fact that they produced the volume they had promised. If so, there plainly was no negligence.

But, even assuming that Mr. Cohon's testimony had been rejected and the testimony of plaintiff's expert, Mr. Townsend, had been wholly accepted, there would still be no negligence on the part of appellants Mr. Townsend said that, to him, the high wholesale volume would seem unusual, although "not impossible" [Tr. p. 317]. He would want to know how it came about. But the steps that Mr. Townsend testified would satisfy him are exactly those taken by Mr. Kamen. Mr. Townsend agreed that he would not listen in on employees

telephone conversations [Tr. p. 357] and that office supervision could not give him the answer [Tr. pp. 356, 357]. To him the only reasonable thing to be done would be to talk to "some" of the customers [Tr. pp. 357, 363]. Mr. Townsend's testimony in this regard showed that he would have been satisfied, had such customers indicated in conversation that they were pleased with the service, or words to that effect [Tr. pp. 357-364].

The record shows that Mr. Kamen did have such conversations with three of the customers, including one of his largest accounts. Each of these customers indicated that he was happy with the service and none indicated anything about Jerome Richard stock or that they were being given any form of rebate or improper transaction [Tr. pp. 405-407]. Surely, in light of such conversations, Mr. Kamen could reasonably believe the representations of Ross and Grossinger that the service Kamen & Company was offering and their contracts were producing the business, even if the expanded volume were considered unusual.

Appellee argues that Mr. Kamen should have detected the Jerome Richards transactions in the early part of 1963, when Ross and Grossinger occupied the "main room" at Kamen & Company and Mr. Kamen was separated from them only by a bannister. But this is contrary to the record. The earliest fraudulent Jerome Richards transaction shown by the record was in March of 1963 [Tr. p. 158], by which time Ross and Grossinger occupied a separate room. Ross and Grossinger

were in the main room, and separated from Mr. Kamen by a bannister, only in January and February of 1963 [Tr. pp. 211, 212]. In any event, the record does not show any substantial amount of Jerome Richards trades made by Ross and Grossinger *from Kamen & Co.'s office* at any time. The only evidence of any such trades being physically made from Kamen & Co.'s office by anyone was the testimony of Mrs. Ginsberg, Ross' secretary, that "occasionally" she was asked by Ross to make such calls [Tr. p. 433]. While Ross and Grossinger *may* have made some Jerome Richards calls from their room at Kamen & Co., this is not shown by the record, and it is entirely possible from the evidence they made their legitimate business calls from the Kamen offices and conducted their Jerome Richards business primarily from other places, such as the Jerome Richards office or the offices of others who may have been associated with them in the fraud.

Without going into further detail with respect to the rather large volume of facts presented on the issue of negligence, and the evidence of the thorough supervision Mr. Kamen exercised over the transactions going through his firm,* it seems clear that the record plainly supports the District Court's finding that Kamen & Co. and its partners exercised due care and were not negligent in preventing the fraud.

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*A somewhat ironical note on the issue of negligence can be found in a comparison of Mr. Kamen's rigorous checks and controls over his firm's activities with the loose procedures followed by plaintiff in his own office. While Mr. Kamen personally checked every transaction going through his office every day, plaintiff (who protested that he was unaware of various things that were happening and documents that were passing through his office) appeared to exercise much less personal supervision, leaving many phases of his business to his employees [Tr. pp. 106, 107, 130.]

IV.

The Trial Court Did Not Err in Refusing to Admit the Affidavit of Francis J. Donnelly.

At the trial, the Court refused to admit Appellee's Exhibit 52, the affidavit of Francis J. Donnelly, an S.E.C. investigator, filed in support of an injunction sought by the S.E.C. in a Civil Action in the United States District Court.

The affidavit on its face (at page 2) states that "the facts set forth in this affidavit are alleged *on information and belief*" (emphasis added) based upon inspection of certain records and on certain interviews. It is evident from the record [Tr. 269; 547-549, and from App. Br. p. 47] that the primary purpose for which plaintiff sought the admission of said affidavit is that paragraph 39 thereof contains affiant's statement of what a Mr. Crowe (not a defendant) told Mr. Donnelly on some other person that defendant Kamen had stated in an alleged conversation with Crowe. That, of course, is a flagrant example of hearsay on hearsay. The remainder of the affidavit dot only consists solely of matters about which the affiant had only second hand knowledge, but matters which were already before the trial court in a proper manner [Compare Affidavit, para. 19 with Tr. 432-437; 438; 441-442; 150-151; 171; 174; Compare Affidavit, para. 16 with Tr. 261-264; 430;431].

Appellee argues that the affidavit should have been admitted as an official document prepared by Mr. Donnelly pursuant to the statutory obligation of the S.E.C. to investigate possible violations of the Securities Act and the Securities & Exchange Act. He cites *Model*

Code of Evidence, Rule 515, and cases from the 2nd, 6th, 3rd, and 10th Circuits in support of the proposition that the affidavit is admissible.

However, the Ninth Circuit case of *Olender v. United States,* 210 F. 2d 795, 800 (9th Cir. 1954), clearly holds that hearsay rule precludes admission of such affidavits notwithstanding the official document exception. Thus, the Court states at page 800:

> "Since the official documents are a substitute for the personal appearance of the official in court, it is generally held that such documents, to be admissible, must concern matters to which the official could testify if he were called to the witness stand. *Vanadium Corp. of America v. Fidelity & Deposit Co. of Maryland,* supra, 159 F2d at page 109; *5 Wigmore on Evidence,* § 1635 (3rd Ed.). *Thus, this circuit and most of the other circuits which have passed on the question have held that the facts stated in the document must have been within the personal knowledge, and observation of the recording official or his subordinates, and that reports based upon general investigations and upon information gleaned second hand from random sources must be excluded.*" [Citations omitted.] [Emphasis added.]

This Court, in the *Olender* case, has already considered the cases and *Model Rule* relied on by Appellee, and at Footnote 1, page 801, expressly rejected them. Moreover, the nature of the document Appellee seeks to have admitted in this case demonstrates the soundness of the *Olender* rule. The investigator's report can hardly be considered sound evidence when it was all based on hearsay and was prepared solely for the pur-

pose of supporting an injunction in a civil action . . . hardly an impartial context.

Appellee also argues that *Olender* has been "sapped of much of its vitality by *Canada Life Assurance Company v. Houston,* 241 F.2d 523 (9th Cir. 1957)." That case involves the admissibility of a coroner's jury verdict and coroner's death certificate. Not only did the documents in that case not involve hearsay, since they merely stated "cause of death unknown," but a final adjudication of a body competent to render such decisions is wholly distinguishable in quality and reliability from an investigator's affidavit advocating a proposed decision. Moreover, the *Canada Life* case simply relied on a 1934 case (*Connecticut General Life Insurance Co. v. Maher,* 70 F. 2d 441, 444 (9th Cir. 1934), without comment and without decision on its effect or relationship to the *Olender* case which fully considered the merits of the issue here present. Even one of the cases relied on by Appellee, *Franklin v. Skelly Oil Co.,* 141 F. 2d 568, 572 (10th Cir. 1944), recognizes that different standards of admissibility apply to findings and results of public hearings and inquests than those applicable to investigators' reports. The former is obviously more reliable and worthy of admission, at least for limited purposes and in the discretion of the trial court.

Finally, it is apparent that, whether or not the document should have been admitted, it was not prejudicial error to have excluded it. Appellee argues that the document could show the number of brokers involved in the manipulation of the Jerome Richard stock, but the record clearly establishes that the trial judge was aware that many brokers were so involved. Plaintiff had two

brokers so testify, introduced depositions upon written interrogatories of three others, and elicited the stipulation that still other brokers were involved. [Tr. 432-437; 438; 441-443; 150-151; 171; 174]. Appellee also points to the reference in the affidavit to the so-called extended presence of Mr. Herman in defendants' office. The record clearly reflects that such evidence was directly introduced and the affidavit would merely have been cumulative [Tr. 261-264; 430-431]. Even the alleged Kamen—Crowe conversation, which under no circumstances should be admissible as it violates every test of admissibility and wholly vitiates the right to cross-examine, is not particularly significant. There was ample evidence of the practice of referring reciprocal business. Therefore, even if the alleged conversation had taken place, a statement by a broker that he was not getting enough reciprocal business, could not be significant. Since the trial judge heard three full days of testimony bearing upon the various issues covered by the affidavit, its rejection could not be deemed prejudicial.

Finally, the transcript, at pages 547-549, clearly discloses that the trial judge properly ruled on the admissibility of the document. He refused to admit it to prove the truth of the statements made by persons other than Kamen. Under any rule, it would seem that Kamen should have the right to cross-examine the persons making such statements with respect to the truth thereof. With respect to the other matters for which Appellee now claims he sought admission of the document, Appellee failed to point out those portions of the document to the trial judge, or to request admission of only such portions of the document as he may argue were admissible.

Accordingly, the trial judge did not err in refusing to admit the document, and even if he did, the error was not prejudicial.

V.

Conclusion.

Over the years, agency cases have toiled with the problem of which of two innocent parties, the principal or the third party dealing with the agent, should bear the loss resulting from an agent's exceeding his authority.

See,

1 Mechem, *Agency,* pp. 528-532.

Some authorities would place the loss on the third party dealing with the agent, since he could have prevented the loss by checking with the principal as to the scope of the agent's actual authority.

1 Mechem, *Agency,* p. 532;

E.g., Ernst v. Searle, 218 Cal. 233, 240 (1933).

Other cases have felt that, both parties being equally innocent, the principal, who selected the agent, should bear the loss.

E.g., County of Macon v. Shores, 97 U.S. 272, 279, 24 L. Ed. 889, 890 (1877).

But this problem exists only where there is innocence on *both* sides—a situation not present in our case. Appellants were found by the District Court to have been neither fraudulent nor negligent, to have neither known nor had reason to know of the transactions in issue. They did all they reasonably could have done to prevent such occurrences.

Plaintiff, on the other hand, was not innocent. He was a broker of long experience. The District Court found that he well knew the transactions violated the Stock Exchange Rules at the time he accepted them. He knew they were unusual and that they could result in the imposition of serious sanctions against appellants. He could easily have checked on the authority of Ross and Grossinger to offer such illegal transactions and thus would have prevented the entire loss. He chose not to do so, but to go forward with these improper transactions to collect his quick and unearned profit.

Surely then, fairness and equity call for the burden of the loss to be borne by plaintiff, rather than by appellants, who had no reason to know these transactions were occurring and no reasonable way to prevent them.

Since, on the facts as found by the District Court, the authorities call for the same result, and, since the District Court quite apparently was applying incorrect legal standards in its determination that apparent authority existed and appellants should be liable, we respectfully suggest that the judgment should be reversed.

Respectfully submitted,

SHEARER & FIELDS,
BERTRAM FIELDS and
BERNARD SHEARER,
Attorneys for Appellants.
and Cross-Appellees.

Certificate.

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those Rules.

BERTRAM FIELDS